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Internal Revenue Service
Memorandum

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to:

ITG Specialist
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from: Patricia P. Wang
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(Tax Exempt & Government Entities)

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subject: Housing Authority Mutual Help Homeownership Opportunity Program

This memorandum contains attorney work-product and attorney client material and may be exempt from disclosure under FOIA and other statutes. No disclosure of this memorandum should be made without consultation with our office.

You have requested our advice regarding the following issues:

1. Whether the interest allocated to the equity accounts of the participants in the Mutual Help Homeownership Opportunity program (the “MHO”) administered by Housing Authority (the “ HA”) is taxable.

2. If the interest is taxable, whether all of the interest allocable to a participant in 2006 should be reportable for that year, or should only the amount actually earned in 2006 be reported for that year.

3. If the interest is taxable, whether HA is required to report the interest to the Internal Revenue Service (the “Service”) and the program participants via Forms 1099-INT.

These issues will be addressed below.

FACTS

MHO Program Generally.

The MHO, a program established by the Department of Housing and Urban Development ("HUD"), is designed to help low-income Indian families achieve home ownership.[1] Under the MHO, HUD pays for 50% of the price to construct a new home and the appropriate Indian Housing Authority ("IHA") pays the other 50%. Eligible Indian families are then able to occupy the home on the condition that the family makes a contribution to the IHA of not less than $1,500.00, which could be through contribution of land, labor, cash, materials, equipment or other similar means. The family must also participate in a home-buying counseling program.

HA's MHO Program.

HA administers a lease-to-own program under the MHO program using the standard HUD Mutual Help and Occupancy Agreement (the "Agreement").

Terms of the Agreement.

Under the Agreement, HA gives each program participant an opportunity to achieve home ownership in the project in return for fulfilling the participant's obligation to (1) make contribution to the development of the project, (2) make monthly payments based on income, (3) provide all maintenance of the home, and (4) satisfy all other program requirements including an annual certification of income and family composition.[2]

Commencement of Occupancy.

The term of the participant's lease under the Agreement commences on the first day of the calendar month following the date specified in the Date of Occupancy[3] and expires when the Initial Purchase Price[4] has been fully amortized in accordance with the

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[1] The regulations governing the MHO, 24 C.F.R. Part 950, Subpart E, has been withdrawn by HUD due to the implementation of the Native American Housing Assistance and Self-Determination Act of 1998 ("NAHASDA"). Therefore, the MHO program is no longer offered by HUD. However, some individuals who participated in the MHO program prior to the enactment of NAHASD are still in existence. Therefore, the withdrawn HUD regulations are still helpful to understand the MHO program.

[2] See Article 1.1 of the Agreement.

[3] Defined as the date specified in a notice provided by HA upon HA's determination that all requirements for occupancy has been met by the participant (i.e., contribution and home-counseling requirements have been met).

[4] The Initial Purchase Price is determined by HA based on the following method: (1) deduct from the

participant's Purchase Price Schedule[5], unless the Agreement is previously terminated or the participant previously acquires ownership of the home.[6]

Homebuyer Payments.

Under the Agreement, each participant must make a monthly payment as determined by HA and approved by HUD. The required monthly payment must equal at least the administrative charge, which is the amount budgeted by HA for monthly operating expenses (i.e., administrative salaries, payroll, taxes, travel, postage, etc.) and general expenses (i.e., fire insurance premiums). The required monthly payment is computed as follows: (1) multiplying adjusted income by a specified percentage (between 15% and 30%, as determined by HA); and (2) deduct from such amount the utility allowance determined for the unit. However, the required monthly payment may not exceed the sum of the administrative charge and the monthly debt service amount shown on the participant's Purchase Price Schedule.[7]

Equity Accounts.

If the required monthly payment exceeds the administrative charge, the excess amount is credited to the participant's Monthly Equity Payments Account ("MEPA"), an equity account that must be maintained separately by HA for each participant under the Agreement. HA credits the MEPA with the amount by which each required monthly payment exceeds the administrative charge. If the participant fails to make a required monthly payment, HA may elect to reduce the MEPA by the amount owned each month towards the administrative charge, until the MEPA has been fully expended.[8]

Another type of account is the Voluntary Equity Payments Account ("VEPA"), which is credited with the amount of any periodic or occasional voluntary payments (in excess of required monthly payment) that the participant may desire to make to acquire

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estimated total development cost of the project certain relocation, counseling, and administrative costs, as well as the participant's contribution for the project, (2) multiply that sum by a fraction (numerator is the prototype cost for the size and type of home being constructed for the participant, and the denominator is the sum of the prototype costs for homes of various sizes within the project), and (3) add the amount chargeable to development costs for acquisition of the home site.

[5] The Purchase Price Schedule is based on amortizing the balance (purchase price less contribution by the participant) over a period of not less than 15 years and not more than 25 years at an interest rate determined by HA. HA may, under the terms of the Agreement, choose to forego charging interest and calculate the payment with interest rate of zero.

[6] See Article V of the Agreement.

[7] See Article VII of the Agreement.

[8] See Article 9.2(a) of the Agreement.

homeownership within a shorter period of time.[9] The MEPAs and VEPAs are designed so that the participant can save and pay off the amount owing on the house and become a homeowner.

The interest is initially earned in a single investment account in the name of HA, in which all program participants' funds are comingled and the program participants are not allowed access to the funds directly. The funds in the MEPA/VEPA belong to the program participants and are kept in trust by HA and managed by HA. Under the Agreement, HA is required to provide annual statements to the program participants regarding the balances in their respective MEPA/VEPA. HA is required to keep track of the balance in these accounts and how much is attributable to each program participant. HA is also required to allocate the interest earned to the MEPA/VEPA for each participant at least once a year.[10]

<u>Participant's Right to Receive or Use Funds</u>.

The Agreement specifically provides that the participant has no right to receive or use the funds in the MEPA/VEPA except as provided in the Agreement, and the participant cannot, without the approval of HA or HUD, assign, mortgage, or pledge any right in this Agreement or to any reserve or account.[11]

<u>Maintenance and Utilities</u>.

Under the Agreement, the program participants are required to keep the homes in good repair and are required to pay the repair and maintenance costs on their homes. If HA determines that the condition of the property creates a hazard to life, health, or safety of the occupants, or if there's a risk of damage to the property if the condition is not corrected, HA or the participant shall correct the problem using the funds in the participant's MEPA/VEPA as HA determines necessary.

If the participant fails to cover the costs of the utilities, HA has the right to pay for the utilities on behalf of the participant and charge the participant's MEPA account.[12]

In addition, under the Agreement, HA may agree to allow the participant to use the funds in the MEPA for the limited purpose of making improvements and additions to the home. In such event, HA has the right to determine whether the participant will be required to replenish the MEPA or if the funds are to be loaned to the

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[9] <u>See</u> Article 9.2(b) of the Agreement.
[10] <u>See</u> Article 14.1 of the Agreement.

[11] <u>See</u> Article 9.5 of the Agreement.

[12] <u>See</u> Article 8.5. <u>See</u> <u>also</u> 24 C.F.R. § 950.428(e).

participant at an interest rate determined by HA. The participants are also restricted from using the MEPA funds for luxury items, as determined by HA.[13]

Use of funds by HA for low-income housing purposes permitted.

HA is authorized to use a portion of the participant's MEPA for low-income housing purposes, provided that a reserve of the participant's MEPA is maintained. The reserve shall be equal to a percentage established by HA and approved by HUD. Interest shall continue to be credited to the homebuyer's account based on the MEPA balance and rate of interest that would have been earned if the funds were invested.[14]

Option to Purchase.

When the balance of the purchase price can be covered from the funds in the MEPA/VEPA, HA will convey the title to the home to the participant. In addition, the participant may also supplement the amount in these accounts with reserves or any other funds of the participant. When the home is purchased by the participant, the net credit balances in the participant's MEPA/VEPA plus the initial contributions made by the participant shall be applied to first pay the initial fire insurance coverage on the house, any settlement costs (if the participant so directs), the purchase price, and finally, the balance is refunded to the participant.[15]

Termination of Participation.

Since the participant is a lessee under the term of the Agreement, the participant acquires no equitable interest in the home until the option to purchase is exercised. If the participant fails to comply with the terms of the Agreement, HA has the option to terminate the Agreement. The participant may also terminate the Agreement any time by providing written notice to HA. Upon termination of the Agreement, the balances in the participant's MEPA is disposed of as follows: (1) MEPA is charged with any maintenance and replacement costs incurred by HA to prepare the home for the next occupant, (2) MEPA is charged with any amounts the participant owes HA, including any required monthly payment; (3) MEPA is charged with the required monthly payment during the period the home is vacant (not to exceed 60 days); and (4) MEPA is charged with cost of securing a vacant unit, cost of notification and associated termination tasks, as well as the cost of storage and/or disposition of personal property. If the balance in the MEPA is insufficient to pay such costs, then the amounts in the VEPA and the participant's initial contribution amount shall be applied to cover such costs. The participant is liable for any costs not covered by the MEPA/VEPA balances. If there is

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[13] See Article 8.7(c) of the Agreement. See also 24 C.F.R. § 950.428(g)(2).

[14] See 24 C.F.R. § 950.437(b)(ii).

[15] See Article 10.5 of the Agreement.

an excess in the MEPA/VEPA after payment of the maintenance and replacement costs, such excess will be refunded to the participant, including all allocated interest earned on these equity accounts.[16]

LAW

Interest Income

Code § 61 provides that, except as otherwise provided by law, gross income means all income from whatever source derived. § 61(a)(4) specifically includes interest in gross income. Interest income includes interest on savings or other bank deposits. Treas. Reg. § 1.61-7(a).

The Service relies on Rev. Rul. 99-44, 1999-2 C.B. 549, to support its position that the interest earned on the participant's equity accounts under the MHO program is includible in the participant's income in the year of allocation under section 61 of the Code. Rev. Rul. 99-44 held that interest earned by an Individual Development Account (IDA) project participant on funds deposited in the participant's personal account is currently includible in the participant's gross income under section 61 of the Code.

IDAs are accounts created under the Assets for Independence Act of 1998 (the "Act") for use by eligible low-income individuals for qualified expenses, which are postsecondary educational expenses, first-time home purchases, business capitalization, or the transfer of IDA funds directly into another IDA for the benefit of an eligible family member. The participants of this program deposit earned income into a personal account, and a qualified entity (such as a § 501(c)(3) organization) provides matching contributions under Federal or non-Federal funds. An IDA consists of two types of funds: Personal Funds and Parallel Funds. Under this program, a separate custodial bank account (i.e., a personal account), for which the qualified entity is the custodian, holds the deposits of the project participant. Personal funds consist of these deposits and any interest earned on the funds in the personal account. Periodically, the qualified entity will note the amount of recent deposits made by a project participant into the participant's personal account on its books. Then, the qualified entity will allocate parallel funds to that participant. Parallel funds consist of a matching amount that corresponds to the amount of the participant's recent deposits and interest.

The qualified entity has complete control over the parallel funds until they are disbursed. The funds may be disbursed only for a qualified expense and only upon written request of the project participant and written approval of a responsible official of the qualified entity. Disbursements of parallel funds are made by the qualified entity directly to the applicable payee (i.e., the educational institution, home seller, the business capitalization account, or the family member's IDA.) as appropriate.

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[16] See Article VII of the Agreement.

The personal funds, including all interest, are the property of the participant. Amounts in the personal funds may be withdrawn for a qualified expense upon written request of the project participant and written approval of a responsible official of the qualified entity. Amounts in the personal funds may also be withdrawn for emergency uses as specified under the Act. In addition, amounts in the personal funds may be withdrawn for any other use, however, such a withdrawal will terminate the participant's involvement in the IDA program, in which case any bookkeeping allocation of parallel funds to that participant will be reversed by the qualified entity on its books.

Based on the foregoing facts, Rev. Rul. 99-44 held that interest earned by an IDA project participant on funds deposited in the participant's personal account is currently includible in the participant's gross income under Code § 61.

Actual and Constructive Receipt of Income

Code § 451(a) provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Treas. Reg. § 1.451-1(a) provides that, gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting.

Treas. Reg. § 1.451-2(a) provides that, income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw has been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial imitations or restrictions.

The doctrine of constructive receipt if based on the principle that income is received or realized by cash method taxpayers "when it is made subject to the will and control of the taxpayer and can be, except for his own action or inaction, reduced to actual possession." Loose v. U.S., 74 F.2d 147 (8th Cir. 1934).

Savings bank interest is taxable when credited to the taxpayer's account, set apart for him, or otherwise made available so that he may draw upon it at any time or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. This is so even if the interest is not posted in the taxpayer's passbook or notice of the amount otherwise given to him. See Treas. Reg. § 1.451-2(b); Gajewski v. Commissioner, 67 T.C. 181, aff'd 578 F.2d 1383 (1978).

If there are substantial limitations or restrictions on the taxpayer's control of the receipt of the income, then there is no constructive receipt until the restrictions are removed. Where a certificate holder of long-term certificates of deposit was precluded from withdrawing principal or interest from his account except with the consent of the bank and only in the event of emergency, interest credited by the bank with respect to the certificate is not includible in the taxpayer's gross income until the taxable year in which the original term of the certificate is concluded, unless received in an earlier taxable year under emergency withdrawal provisions. See Rev. Rul. 73-487, 1973-2 C.B.153.

Courts have determined that the following conditions are generally necessary to tax an amount under the doctrine of constructive receipt:

1. the amount must be due;
2. the amount must be appropriated on the books of the obligor;
3. the obligor must be willing to pay;
4. the obligor must be solvent and able to pay; and
5. the obligee must have knowledge of the foregoing facts.

The obligee's demand for payment must be the only thing that would be necessary for payment. See Johnson v. Commissioner, 25 T.C. 499 (1955); Jumbo v. Commissioner, T.C. Memo 2002-273; Gullett v. Commissioner, 31 B.T.A. 1067 (1935). The amount credited to an individuals' account must be subject to unqualified demand. See Robinson v. Commissioner, 44 T.C. 20 (1965).

Information Reporting Requirements

Code § 6049(a) provides that every person (1) who makes payments of interest aggregating $10 or more to any other person during any calendar year or (2) who receives payments of interest as a nominee and who makes payments aggregating $10 or more during any calendar year to any other person with respect to the interest so received, shall make a return according to the forms or regulations prescribed by the Secretary, setting forth the aggregate amount of such payments and the name and address of the person to whom paid.

Code § 6049(b)(1)(B) includes in the definition of interest any interest on deposits with persons carrying on the banking business. Section 6049(b)(1)(C) includes in the definition of interest any amounts paid by a mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, industrial loan association or bank, or similar organization, in respect of deposits, investment certificates, or withdrawable or repurchasable shares.

Code § 6049(d)(1) provides that the term person includes any governmental unit and any agency or instrumentality thereof and any international organization and any agency or instrumentality thereof.

ANALYSIS

Issues 1 and 2

As a general rule, interest earned by a taxpayer constitutes gross income and is fully taxable. In Rev. Rul. 99-44, the personal funds, including all interest, are the property of the IDA participant and may be withdrawn at any time. Here, even though the funds in the equity accounts are held in trust by the HA for the benefit of the program participants, the funds, including interest earned thereon, remain property of the program participants. Therefore, the interest earned on the funds in the equity accounts is fully taxable. However, the main issue is when the interest becomes taxable to the program participants. Unlike the facts under Rev. Rul. 99-44, the MHO program participant's access to the funds held in the equity accounts, including interest earned thereon, are subject to substantial limitations and restrictions.

Based on the treasury regulations and case law cited above, income is constructively received by a taxpayer in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw has been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial imitations or restrictions.

Under the Agreement, the program participants' right to control and access the funds, including the interest thereon, are subject to various limitations. For example, during the period of occupancy, if HA determines that the home needs to be repaired, HA has the right to use the funds in the participant's equity accounts as HA deems necessary. In addition, HA also has the right to pay for the utilities on behalf of the participant and charge the participant's equity account. Although the program participant may use the funds in the equity account for the limited purpose of making improvements and additions to the home, HA has the right to determine whether the participant will be required to replenish the equity account or if the funds are to be loaned to the participant at an interest rate determined by HA.

In addition, although HA is authorized to use a portion of the participant's MEPA for low-income housing purposes (provided that a reserve of the participant's MEPA is maintained), HA must continue to credit the interest to each homebuyer's account based on the MEPA balance and rate of interest that would have been earned if the funds were invested.

Also, the Agreement specifically provides the participant cannot, without the approval of HA or HUD, assign, mortgage, or pledge any right in this Agreement or to any reserve or account.

Given the limitations and restrictions set forth in the Agreement, a participant's right to the interest earned on the funds in his equity accounts is subject to substantial limitations or restrictions. Under the Agreement, the participant may terminate the Agreement any time by providing written notice to HA. Upon termination of the Agreement, the balances in the participant's equity accounts will be used to pay certain maintenance and replacement costs as well as any unpaid required monthly payment. If there is an excess in the equity accounts after payment of the maintenance and replacement costs, such excess will be refunded to the participant, including all allocated interest earned on these equity accounts. In addition, when the home is purchased by the participant, the net credit balances in the participant's equity accounts are refunded to the participant after first being used to pay certain costs and the balance of the purchase price on the home. Therefore, there is no constructive receipt of the interest income until these limitations are removed, i.e., when a participant terminates the Agreement or exercises the option to purchase.

Issue 3

The payment of any interest earned on the equity accounts pursuant to the MHO program is subject to information reporting requirements under Code § 6049, since this is the type of interest that falls under the definition of interest under Code § 6049(b). In addition, HA falls within the definition of person under Code § 6049(d)(1) because it is an agency or instrumentality of the tribal government. Therefore, HA is responsible for issuing the Forms 1099-INT to the program participants.

If you have any questions, please contact Patricia P. Wang at (213) 894-3027 x 182.

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